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ABSTRACT

A study was done of how interest rate floors on certain guaranteed student loans affect the federal government's and students' costs when rates on short-term government securities decline. The study developed cost comparisons using fixed and variable loan interest rates. For comparison Department of Education projections of loan volumes for fiscal year 1992-97 were used. The results indicated that establishing a variable interest rate structure for guaranteed student loans, while retaining the current caps, could save the federal government and student borrowers several hundred million dollars in future interest payments. Recent declines in the Treasury bill yields have caused interest rates to fall on certain kinds of loans under the Stafford Student Loan Program but not on others. Of the loans in the Stafford Student Loan Program, Stafford and consolidation loans have interest rate floors that prevent borrowers and the government from benefiting when Treasury Bill yields drop. If the loan programs that now have interest rate floors were to have variable interest rates, the federal government and student borrowers could pay in fiscal year 1992 about $100 million and $143 million less in interest payments respectively. Included are two figures and two appendixes (JB)

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United States General Accounting Office

GAO

Report to the Honorable
George D. Mitchell, U.S. Senate

July 1992

GUARANTEED STUDENT LOANS

Eliminating Interest Rate Floors Could Generate Substantial Savings

HE 025 706

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GAO

United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

B-249111

July 21, 1992

The Honorable George D. Mitchell
United States Senate

Dear Senator Mitchell:

This report responds to your request for information on how interest rate floors on certain guaranteed student loans affect the federal government's and students' costs when rates on short-term government securities decline. On January 17, 1992, we briefed your staff on the results of our preliminary analysis on this subject. Subsequently, a provision to eliminate the interest rate floor on Stafford loans was included in the Senate bill (S.1150) proposing to reauthorize the Higher Education Act of 1965. This report summarizes and expands on the information we provided to your staff.

Results in Brief

Establishing a variable interest rate structure for guaranteed student loans, while retaining the current caps, could save the federal government and student borrowers several hundred million dollars in future interest payments. Recent declines in Treasury bill (T-bill) yields have caused interest rates to fall on certain kinds of loans under the Stafford Student Loan Program, but not on others.[1] Parent Loans for Undergraduate Students (PLUS) and Supplemental Loans for Students (SLS) carry interest rates that vary with T-bill yields, thus allowing borrowers to save on interest charges when T-bill yields decline. In contrast, Stafford and consolidation loans have interest rate floors that prevent borrowers and the government from benefiting when T-bill yields drop. If Stafford and consolidation loans had variable interest rates, the federal government and student borrowers could pay in fiscal year 1992 about $100 million and $143 million less in interest payments, respectively.

The potential cost savings associated with applying variable interest rates to these kinds of loans could be even more substantial if loan volumes continue to grow and the T-bill yields similar to those recently observed prevail in the future. For example, given the Department of Education's 5-year forecast of loan volume, replacing the interest rate floor on Stafford loans with a variable rate could save the federal government about $545 million in interest payments—a present value of $387 million—in

[1]The Stafford Student Loan Program is the umbrella term for four separate loan programs: Stafford Loans, Parent Loans for Undergraduate Students, Supplemental Loans for Students, and consolidation loans.

fiscal year 1997. This assumes a variable rate of 7 percent, 1 percent lower than the 8-percent interest rate floor.

Background

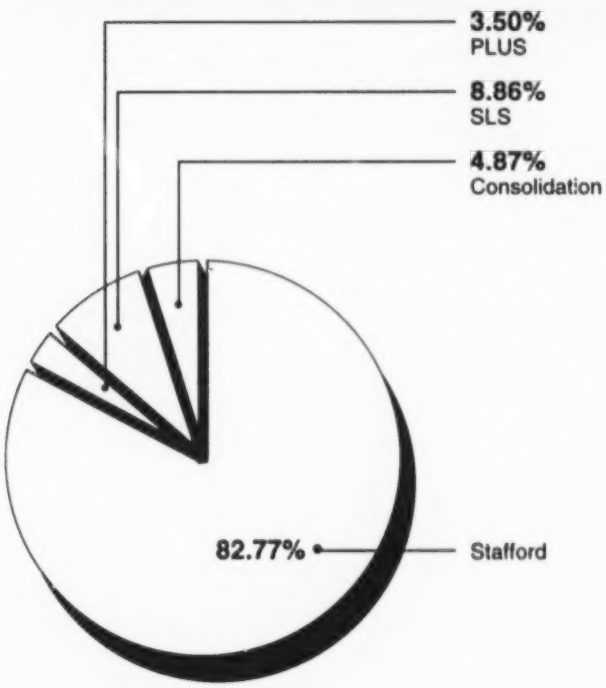
Stafford loans, PLUS, and SLS are federally insured student loan programs that provide financial assistance to students attending postsecondary education institutions. These programs are designed to serve students with differing needs. Borrowers must demonstrate financial need for Stafford loans but not for PLUS and SLS. Stafford loans generally serve students whose incomes or family incomes are insufficient to cover the student's education costs. PLUS serves dependent students whose family income exceeds the eligibility requirements for Stafford loans. SLS usually serves independent students whose circumstances are similar to students served under PLUS.[2]

Borrowers are allowed up to 10 years to repay these loans. However, borrowers who have multiple student loans usually can take advantage of the Consolidation Loan Program. Consolidation loans generally result in a reduced monthly payment because borrowers can extend their repayment schedule up to 25 years, depending on the amount owed.

Stafford loans comprised about 83 percent of all outstanding loans as of September 30, 1991, as figure 1 shows.

[2]Students can borrow up to $2,625 a year in Stafford loans for their first 2 undergraduate years, up to $4,000 a year for their remaining undergraduate years, and up to $7,500 a year for graduate school. In addition to Stafford loans, parents of students can borrow up to $4,000 in PLUS loans per year for each dependent child enrolled in undergraduate or graduate studies at least half-time. Independent undergraduate or graduate students can borrow up to $4,000 a year under the SLS program.

Figure 1: Outstanding Guaranteed Student Loans (FY 1992)



Source: The Department of Education

Commercial lenders, such as banks and credit unions, generally provide the capital for Stafford, PLUS, SLS, and consolidation loans. Guaranty agencies, which administer the loan programs at the state level for the Department of Education, insure lenders against losses from defaults. The Department, in turn, reinsures guaranty agencies.

To ensure an adequate stock of private loan capital, the federal government provides lenders who participate in guaranteed student loan programs a guaranteed rate of return—termed the special allowance. This is intended to yield lenders a competitive rate of return. In general, the government guarantees lenders interest equal to the bond equivalent yield on the 91-day T-bill plus a "special allowance factor"—currently

3.25 percent. If the borrower's interest rate is below this yield, the Department pays lenders the difference.

Current Interest Rate Structures

Legislative formulas determine the interest rates on guaranteed student loans. Stafford loans carry a two-tiered interest rate; 8 percent is charged to eligible first-time borrowers through the first 4 years of repayment and 10 percent thereafter. If the yield on 91-day T-bills plus 3.25 percent goes below 10 percent during the fifth and subsequent repayment years, monthly payments remain unchanged but excess interest payments are used to reduce loan principal. As such, the interest rate during this repayment period becomes a variable rate with a 10-percent cap. PLUS and SLS loans carry variable interest rates equal to the bond equivalent yield on 52-week T-bills plus 3.25 percent, capped at 12 percent. Consolidated loans carry a fixed interest rate equal to the weighted average of the loans consolidated or 9 percent, whichever is higher.

Scope and Methodology

In conducting this review, we examined the provisions of the Higher Education Act of 1965, as amended, that pertained to the interest rates for the various kinds of guaranteed

student loans. For the study, we focused on the interest rate floors charged to the federal government and student borrowers for Stafford and consolidation loans. Our study assumed that the caps on the students' interest rate for the Stafford (8 percent during the first 4 years and 10 percent thereafter) and consolidation (the higher of the weighted average of consolidated loans or 9 percent) programs will remain in effect.

To determine how the interest rates on Stafford and consolidation loans affect the government's and borrowers' interest costs when Treasury bill yields decline, we developed cost comparisons using fixed and variable loan interest rates. For comparison, we used Department of Education projections of loan volumes for fiscal years 1992-97. In our analysis for fiscal year 1992, we used a fixed interest rate equal to the actual bond equivalent yields on 91-day T-bills for the first 2 quarters of 1992 and the Department's projections of T-bill rates for the remaining 2 quarters. We used a variable interest rate equal to the 91-day T-bill yield plus the special allowance factor of 3.25 percent. In our computations for fiscal year 1997, we used the Department's loan volume projections for fiscal year 1997 and selected T-bill yields.

Our analysis does not consider Stafford loans financed from tax-exempt sources, which have an interest rate floor of 9.5 percent. To provide liquidity to the student loan system, the law allows government and not-for-profit agencies to use tax-exempt financing to purchase Stafford loans. Because of federal restrictions on state and local governments use of tax-exempt securities, the proportion of Stafford loans financed with tax-exempt sources has been relatively small in recent years. According to the Department, these loans comprised about 10 percent of Stafford loans made in fiscal year 1991. As our estimates do not reflect the use of tax-exempt financing, our computations probably understate the interest cost savings associated with eliminating the interest rate floor on Stafford loans.

We conducted our review between January 1992 and April 1992 in accordance with generally accepted government auditing standards. Selected GAO products concerning student loans are listed opposite the inside back cover of this report.

Interest Rate Floors Have Precluded Savings Opportunities

Unlike PLUS and SLS borrowers, neither the federal government nor Stafford and consolidation loan borrowers have an opportunity to realize interest cost savings when T-bill rates decline. SLS and PLUS borrowers benefit from decreases in T-bill rates because the interest rates on these loans vary directly with T-bill rates. For example, between June 30, 1989, and July 1, 1992, the interest rates on these loans dropped from about 12 to 9 percent. This decline in interest rates saved student borrowers about $178 million over this period. In contrast, the interest rates on Stafford and consolidation loans remained constant because these loans have interest rate floors.

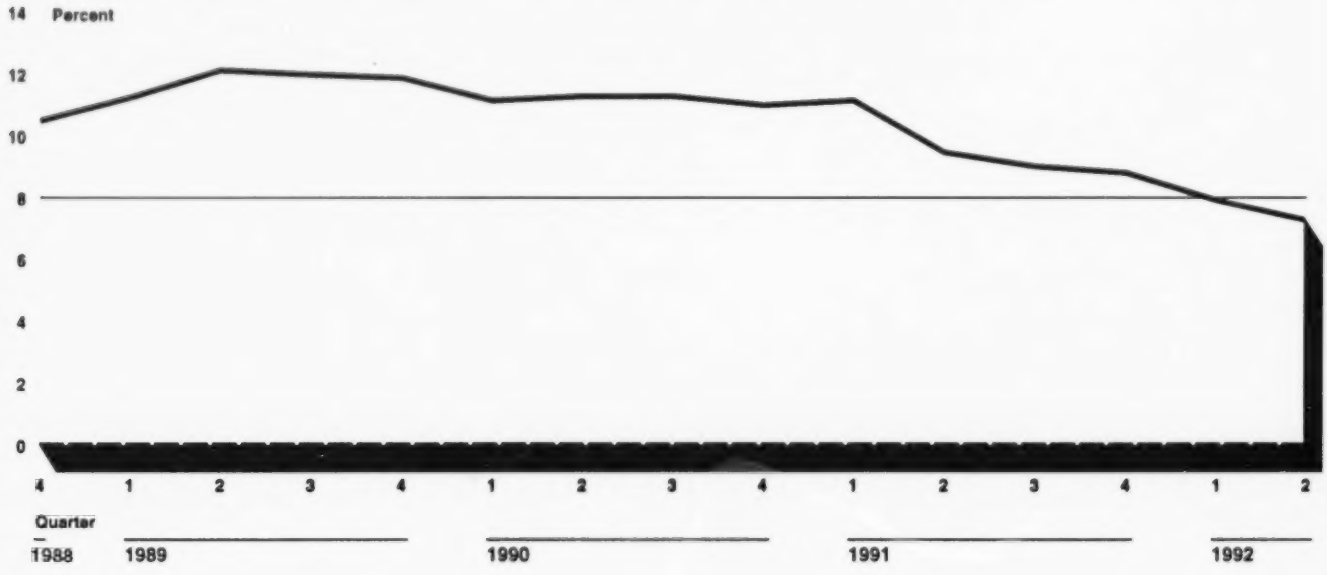
The Federal Government Has Not Benefited Fully From T-Bill Rate Declines

As long as Stafford loan borrowers attend school at least part-time and during statutory loan deferment and grace periods, the Department makes interest payments on the students' behalf. When it does so, the rate is set at 3.25 percent above the bond equivalent yield on 91-day T-bills, but not less than 8 percent. Thus, when T-bill rates are above 4.75 percent the Department pays lenders interest at rates higher than 8 percent. However, when T-bill rates drop below 4.75 percent the Department continues to pay interest at 8 percent due to the interest rate floor.

Until recently, the interest rate floor has not been a factor in the Department's interest payments on Stafford loans because T-bill rates

remained above 4.75 percent. However, during the first 2 quarters of fiscal year 1992, the bond equivalent yield on 91-day T-bills dropped to 4.66 and 4.02 percent, respectively. Under a variable rate equal to the T-bill rate plus 3.25 percent, this decline in T-bill yields would have resulted in interest rates of 7.91 and 7.2 percent, respectively, during these 2 quarters, as figure 2 illustrates.

Figure 2: Comparison of Stafford Interest Rate Floor and Yield on 91-Day Treasury Bills Plus 3.25 Percent



Legend:

——— Interest rate floor

━━━ T-bill rates + 3.25 percent

Source: Department of Education

The Department projects 91-day T-bill rates of about 4.3 and 4.5 percent for the third and fourth quarters of fiscal year 1992, respectively. This would result in an average quarterly T-bill rate of about 4.37 percent for

1992. Under a variable interest rate equal to the T-bill plus 3.25 percent, this T-bill rate would equate to an interest rate of about 7.62 percent.

To determine the effect of the interest rate floor on the Department's interest costs, we estimated the Department's costs with and without the 8-percent floor for fiscal year 1992, assuming the variable interest rate described above. The Department expects the average balance of outstanding Stafford loans subject to interest payments to total about $20.8 billion in 1992. With the floor, the Department could pay approximately $1.7 billion in interest payments. In contrast, without the floor, the Department would make interest payments totaling about $1.6 billion in 1992—a savings of about $100 million.

Recent Stafford Borrowers Have Not Benefited From Declines in T-Bill Rates

Like the Department, many Stafford loan borrowers have not benefited from the recent decline in market rates. Borrowers who obtained their first Stafford loans since July 1, 1988, pay interest at a fixed rate of 8 percent during the first 4 years of repayment. The Department expects about $26.5 billion in Stafford loans to enter repayment during 1992. At a fixed interest rate of 8 percent, student borrowers would incur about $2.1 billion in interest payments on these loans. In contrast, if these borrowers paid interest at the variable rate of T-bill plus 3.25 percent (about 7.62 percent), their annual interest cost would be about $2 billion, or about $100 million less than the costs under the fixed rate.

Consolidated Loan Borrowers Do Not Benefit From Declines in T-Bill Rates

Like Stafford borrowers, consolidation borrowers do not realize benefits from a decline in T-bill rates because these loans have interest rate floors. A variable rate on consolidation loans would be even more beneficial to consolidation borrowers because the interest rate floor on such loans is often higher than the floor on Stafford loans.

According to the Department's estimates, the total outstanding balance of consolidation loans will be about $3.1 billion in 1992. At a 9-percent fixed rate, the borrowers could incur interest charges of about $279 million. In contrast, at an average variable rate of 7.62 percent, their interest costs could have been about $237 million—approximately $42 million less than their costs at the fixed rate.

Eliminating Interest Rate Floors Could Lead to Significant Savings

Eliminating the interest rate floors on Stafford and consolidation loans could yield significant future cost savings to the federal government and student borrowers. Using the Department's 5-year loan volume projection

(FYs 1993-97), we estimated that about $55 billion in Stafford loans made after October 1, 1992, would be outstanding by 1997. At a fixed 8-percent rate, the interest costs on these loans would be about $4.361 billion in 1997. For illustrative purposes, suppose a variable interest rate equal to the T-bill plus 3.25 percent applied to these loans. Under this condition, a T-bill rate of 3.75 would equate to a variable interest rate of 7 percent. At this rate, the interest costs would total about $3.816 billion, or about $545 million less than the costs expected with the fixed rate. These cost savings would accrue to either the Department or the student borrowers, depending on which was making the interest payments.

We used a range of T-bill rates to compute several other examples of cost savings that could result from adopting a variable interest rate for Stafford and consolidation loans (see app. I).

No Impact on Loan Supply Anticipated

Allowing the interest rate on Stafford and consolidation loans to vary with the yield on T-bills should not affect student accessibility to loan capital. Variable interest rates have not had an adverse impact on SLS or PLUS program growth. Since the Education Amendments of 1986 established variable interest rates for SLS and PLUS, these programs have experienced substantial growth. For the SLS program, the number of loan originations and dollar volumes increased about 479 and 511 percent, respectively, between fiscal years 1986 and 1990. For the PLUS program, the number of loan originations and dollar volumes increased about 197 and 264 percent, respectively, over the same period.

Moreover, like other investors, student loan lenders base their investment decisions on the expected rate of return, taking risk into account. Establishing a variable-rates for student loans would generate the risk of downward interest rate movements. However, the relatively low T-bill rates of recent months were last observed over 20 years ago and are not expected to prevail for very long. Most forecasting authorities do not expect rates to decline to similar levels in the foreseeable future. Further, in an earlier report we found that the special allowance factor adequately compensates lenders for any risks they assume.[3] Accordingly, we do not believe that assigning variable interest rates to new Stafford and consolidation loans will cause student loan lenders to modify their investment strategy.

[3]Stafford Student Loans: Lower Subsidy Payments Could Achieve Savings Without Affecting Access (GAO/HRD-92-7, Jan. 6, 1992).

Conclusions

Interest rate floors on Stafford and consolidation loans prevent the government and students from realizing savings when T-bill rates decline below the floors. While the occasions may be infrequent and temporary, minor differences between the current interest rate floors and a lower variable rate entail substantial economic implications. Eliminating these interest rate floors and using variable rates, similar to those applying to SLS and PLUS, would (1) provide more consistency among the various guaranteed student loan programs, (2) potentially save the government and students several hundred million dollars in future interest costs, and (3) not affect student access to loan capital.

Recommendation to the Congress

We recommend that the Congress revise the Higher Education Act, as amended, to make the interest rate on future Stafford and consolidation student loans vary with the yield on Treasury bills, not to exceed current maximum rates.

We did not obtain written agency comments on this report but did obtain the views of officials at the Department of Education and the Student Loan Marketing Association, who generally agreed with its contents. We have incorporated their comments as appropriate. Copies of the report are being sent to the Secretary of Education, congressional committees, and other interested parties. It will be made available to others on request.

The report was prepared under the direction of Linda G. Morra, Director of Education and Employment Issues, who can be reached on (202) 512-7014. Other major contributors are listed in appendix II.

Sincerely yours,

Lawrence H. Thompson

Lawrence H. Thompson
Assistant Comptroller General

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Abbreviations

PLUS	Parent Loans for Undergraduate Students
SLS	Supplemental Loans for Students
T-bill	Treasury bill

Potential Interest Cost Savings to the Federal Government From Variable Interest Rates

Dollar amount in millions

91-day T-bill rate	Loan interest rate	Annual savings by fiscal year				
		1993	1994	1995	1996	1997
4.50%	7.75%	$14	$ 42	$ 72	$103	$136
4.25	7.50	28	84	144	207	273
4.00	7.25	41	127	216	310	409
3.75	7.00	55	169	288	414	545
3.50	6.75	69	211	360	517	681
3.25	6.50	83	253	432	630	818
3.00	6.25	97	295	504	724	954

Note: Figures shown (1) were based on Department of Education projections of future loan volumes and (2) assume a special allowance factor of 3.25 percent.

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Related GAO Products

Stafford Student Loans: Lower Subsidy Payments Could Achieve Savings Without Affecting Access (GAO/HRD-92-7, Jan. 6, 1992).

Guaranteed Student Loans: Profits of Secondary Market Lenders Vary Widely (GAO/HRD-90-130BR, Sept. 28, 1990).

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